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Winning the War for Talent: How Cash Balance Plans Change the Game

From the board room bunkers to the cubicle trenches, competition to find and retain top talent is becoming tougher than ever. Leading global consulting firm McKinsey & Company recently updated their notable 1998 study, *The War for Talent,* concluding that the most important corporate resource for the next 20 years will be talent. More important than capital or technology, talent is also the resource in shortest supply. In our highly competitive global economy, the best people are willing to change jobs often, and attrition rates are climbing in many organizations.

Now more than ever, the quality of company-sponsored retirement plans plays a crucial role in attracting and retaining first-rate talent. For many high income professionals, retirement plans are one of the most important sources of wealth accumulation. And for some companies, retirement plans can be the single greatest source of tax benefits. Consequently, any organization that wants to win the war for talent must have a highly competitive retirement package.

So what makes a retirement plan compelling to talented, in-demand professionals? A generous 401(k) Profit Sharing plan is a good start. Add a Cash Balance Plan, and the attraction is significantly greater. In fact, adding a Cash Balance Plan to an existing retirement package is often the most cost-effective way to create a winning retirement package.

The Retention Power of a Cash Balance Plan

Let's illustrate the concept by looking again at the world of law firms. With a Cash Balance Plan in place, law firm partners are able to have more of their pre-tax income deferred to retirement accounts. Recent tax law changes and plan design options allow tax-deductible Cash Balance Plan contributions from $35,000 to over $200,000 annually, depending on participants' ages. Law firms making these Cash Balance contributions have greatly improved partner satisfaction with retirement plans.

Most retention efforts focus on the first few years of employment. Losing an attorney after a long recruiting effort can be demoralizing and expensive.

While it's expensive to lose talented attorneys early in their careers, it's even more devastating to lose them mid-career. Mid-career lawyers are often in their prime in terms of productivity, skill and client retention. Their loss can greatly affect the firm's quality of work in addition to its bottom line.

A law firm's retirement plan can be a crucial factor in an attorney's decision to leave. Attorneys in their 40s have often paid down student loans and gotten their mortgages in check. Looking ahead at their financial futures, they typically feel behind in retirement savings. Attorneys, like physicians, start later than many professionals in saving for retirement due to student loans and years of lower paid work as associates. If the firm doesn't help them meet their financial objectives, they will probably find another firm that can.

The single most important step a law firm, medical group, or any competitive organization can take to improve its retirement plan is to increase pre-tax contributions so partners can grow their qualified retirement accounts. This can be accomplished by adding a Cash Balance Plan to the retirement plan already in place—typically a 401(k) Profit Sharing Plan. By adding Cash Balance, contribution amounts can double or even triple for partners in their 40s and 50s.

The Limited Recruitment Value of 401(k) Plans

Before looking more closely at the competitive features of Cash Balance Plans, we need to step back and review why winning companies don't limit themselves to 401(k) plans. It's true that 401(k)s remain the fastest growing type of retirement plan in the US, but they pose serious challenges in terms of low contribution limits and the investment risk borne by plan participants. It helps to know that 401(k)s were never intended to replace the traditional defined benefit pension plans that once dominated in corporate America.

As costs for employee medical benefits skyrocketed in the 1980s and 1990s, many business owners had to cut costs on the pension side. Many moved away from costlier, traditional defined benefit pension plans toward 401(k) plans which were less expensive to operate and allowed greater flexibility for employer contribution levels. This shift also removed the investment risk for employers.

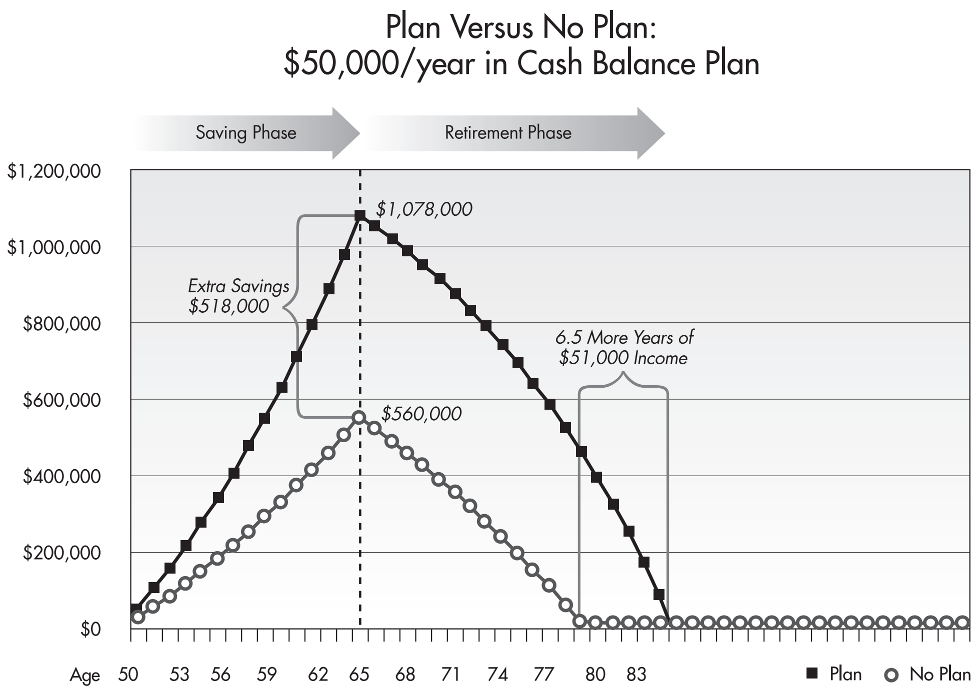
Unfortunately, the explosion in 401(k) plans has had serious consequences: more and more people are retiring without enough funds to support their standard of living. Typically, the problem is that they did not (or could not) defer enough income. A second issue is that 401(k) accounts heavily invested in equities suffered devastating market losses in the recent bear markets of 2000 and 2008. Tens of thousands of Americans saw 50% or more of their 401(k) savings wiped out.

For 2010, the maximum annual 401(k) plan contribution is either $16,500, or for those 50 or older, $22,000. A Profit Sharing plan can provide another $32,500 per year of employer contributions. Unfortunately, once the $49,000 or $54,500 maximum annual contribution has been reached, these plans are maxed out for the year. For professionals and business owners who had to delay retirement savings until mid-career, it's almost impossible to catch up on building healthy retirement portfolios given the limits of defined contribution plans.

Why Winners Need a Higher Octane Qualified Plan

Facing the limits of a 401(k) Profit Sharing plan, some business owners and high income professionals turn to savings and investment vehicles outside of a qualified plan, such as insurance products and after-tax retirement accounts. However, that means missing out on the enormous financial benefits of a tax-favored qualified plan.

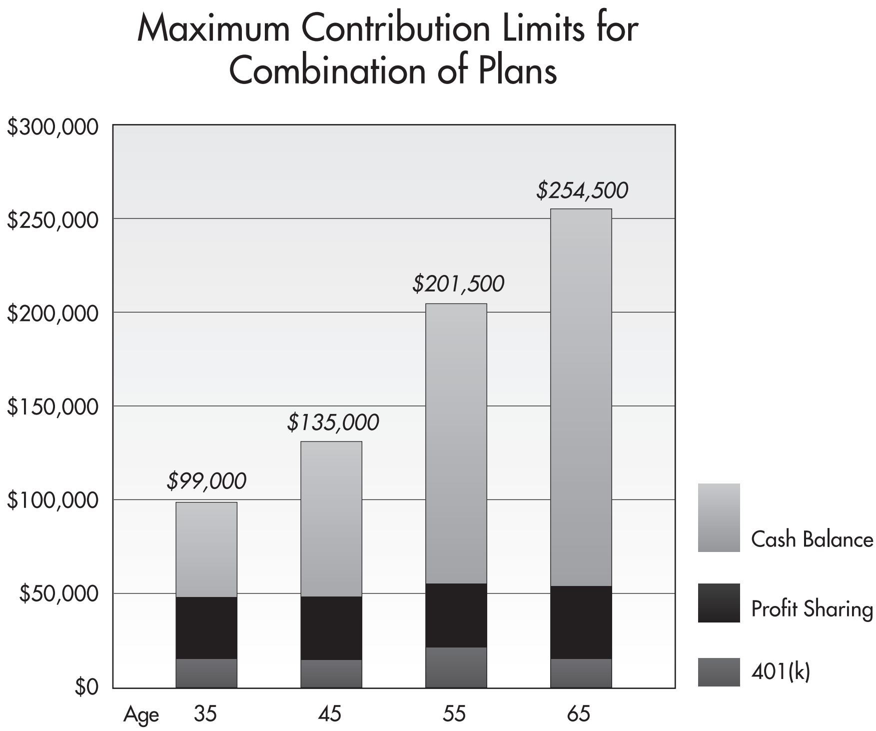
The following graph is an illustration of the difference in an account balance over time between saving $50,000 pre-tax in a qualified plan and paying the tax on $50,000 and saving the difference.



Assumptions: Tax rates the same both phases (45%); interest earned in plan: 5%; interest outside plan: 6%; long/short term capital gains rate average: 33%

Adding a Cash Balance Plan (or a defined benefit plan) is the only way to increase contributions within a qualified plan after reaching the limits of a 401(k) Profit Sharing plan. As our case studies have shown, business owners can increase contributions substantially—up to $200,000 per year of deferred taxable income depending on age.

The chart below makes it easy to see just how much of an impact adding a Cash Balance Plan can make. The difference in tax-deferred savings is huge, and increases significantly based on age. Considering how many talented mid-career professionals urgently need to accelerate their retirement savings, it's easy to see the recruiting power of a Cash Balance Plan. And when it comes to retaining key partners and staff, the allure of Cash Balance is just as significant.



Watching Your Money Grow: the Appeal of Participant Statements

Cash Balance Plans offer many advantages over traditional defined benefit plans. One of the most appealing is that each participant has an individual account and can track its growth on an annual participant statement. Each owner or employee also knows exactly how much is being contributed on his or her behalf, what the interest crediting rate is, and what the final benefit will be. However, because plan assets are pooled and invested collectively, these accounts are "hypothetical" and the plan participant bears no investment risk.

Cash Balance participant accounts are maintained by the third party administrator (TPA), who generates annual participant statements like the one shown below:

Sample Participant Statement

Period of 1/1/2010 through 12/31/2010

John Doe
4944 Lombardy Drive
Los Angeles, CA 90605

Beginning account balance $143,549.00

2010 employer contribution ....$ 70,000.00

2010 interest credit $6,502.77

Ending account balance $220,051.77

Vested percent on 12/31/10 ....100%

Vested balance on 12/31/10 ....$ 220,051.77

Security and Stability: the Comfort of a Guaranteed Interest Credit

After the wild market ride of 2008, owners and employees alike are looking for security, longing for reassurance that their retirement savings can grow safely and steadily. This is yet another key recruitment and retention feature of Cash Balance Plans: the annual interest credit is guaranteed and is not dependent on the plan's investment performance. Furthermore, the nature of a Cash Balance Plan dictates that plan assets be invested conservatively—typically in diversified fixed-income portfolios.

Most Cash Balance Plans are tied to a conservative benchmark similar to the 30-year Treasury rate, which has hovered around 5% in recent years. All accounts are invested collectively by the Plan Trustee in one pooled account, taking away the risk factor of individual account holders choosing their own investments. We'll review all of these investment issues in more detail in Chapter 4.

Case Study: a Small Business Owner Wins the War for Talent

As a small business owner, what would you do if the government offered to pay retirement benefits to your employees? And give you all the credit? And pay you for letting them do it?

This is exactly what the government is doing for many small business owners who set up qualified plans like a Cash Balance Plan. Let's look at an example to see just how valuable this tax incentive can be.

Richard Rozanski is a 40-year-old entrepreneur with a small but profitable furniture manufacturing firm in Florida. Last year, Richard's company contributed $50,000 to a Cash Balance Plan. Of the total, $40,000 went into Richard's account and the remaining $10,000 was divided among the accounts of his four employees as a tax-deferred benefit. The money went into a trust fund where it will grow tax-free until it is paid out as retirement benefits. Richard's company gets a tax deduction for the full $50,000.

Fast-forward 25 years. Richard is now 65 years old and his own account is worth $2.5 million, assuming he has continued making contributions every year and the plan assets earned an annual average of 5%. The employees watched their accounts grow to $500,000 over the years. Without a doubt, the Cash Balance Plan helped Richard attract and retain many talented staff members.

Without the company retirement plan, Richard may have paid himself most of the $50,000 as additional salary, which would be taxable income. If he had invested the extra cash, he would have paid taxes each year on the investment income. At the end of 25 years, at a marginal tax rate of 40%, he would have $1,125,000—less than half the amount he'd have in his Cash Balance Plan retirement account.

Richard does have to pay taxes when he withdraws his money from the plan. At the 40% tax bracket, even if he took it all out and paid all of the taxes at age 65 he would net $1,500,000, about 33% more than he would have without a retirement plan. These numbers get even better if he continues to defer paying taxes until he needs the money to live on or until the government requires it starting at age 70½.

So, by adding a Cash Balance Plan, at the end of 25 years, Richard has more money, his employees have more money, and his employees give him all the credit!

Three Questions to Ask Before Adding a Cash Balance Plan

Plan design is the due diligence phase of adding a plan to a company's overall retirement program. Work with your actuarial partner to consider the following issues for appropriate plan design:

1. **Which subgroups within the organization will benefit from the plan?**
   Using the medical group example, the group may include shareholder doctors, other physicians, mid-level providers including nurse

practitioners and various levels of administrative staff. Depending on compensation level and the goals of the group, not all subgroups need to be included in the plan. Some firms exclude or 'carve out' groups that receive other types of benefits, such as sales staff who earn commissions.

2. **What employer contribution levels are necessary to ensure compliance with IRS nondiscrimination testing?**
   All retirement plans that enjoy tax-qualified status must pass nondiscrimination testing. These tests are designed to prevent the skewing of benefits in favor of highly compensated employees (those earning $110,000 or higher in 2010). These tests are complex, but they essentially compare rates of deferral and benefits between the "highly compensated" and the "non-highly compensated." Most plans must be tested annually.

3. **Does a Cash Balance Plan make sense for our organization?**
   Due to the complexity of Cash Balance Plans, they involve higher administration fees than 401(k) plans. The decision to adopt a Cash Balance Plan should include a careful analysis of the organization's current and future benefit objectives.

Cash Balance Plans have important legal compliance and actuarial certification requirements. It can be costly and painful to work with an inexperienced provider who is unfamiliar with these issues. Advisors and their clients should seek counsel from an actuarial firm with proven Cash Balance Plan experience, a firm familiar with the intricacies of companies such as theirs. Partnership with trusted experts is the best way to ensure cost-effective long term success for your retirement plans.

Quick Summary of Cash Balance Plan Benefits:

- ✓ *Allows* higher contribution amounts.
- ✓ *Accelerates* retirement savings.
- ✓ *Combines* nicely with 401(k) and/or Profit Sharing Plans for even higher contribution amounts.
- ✓ *Easy to understand and communicate benefits* since participants have individual accounts.
- ✓ Growth of retirement benefit is *not* dependent on investment earnings.
- ✓ *Portable* in the event of job-change or termination.
- ✓ Assets are *protected* from creditors in the event of bankruptcy or lawsuits.

What's Next for Financial Advisors?

What happens to your client's money once it's invested in a Cash Balance Plan? Financial advisors and their clients are not expected to understand all the nuances of the actuarial science behind hybrid retirement plans. However, it's prudent to understand the key investment principles for Cash Balance Plans in order to make informed decisions. Selecting an appropriate investment strategy is critical to the long-term success of the plan. The next chapter explains the investment side of the equation.